EXHIBIT 1

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December 31, 2000

Mr. Joseph Stechler
15 Engle Street
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Re: Investment Transactions

Dear Mr. Stechler:

You, ("Investor") has requested our opinion regarding certain U.S. federal income tax consequences of various investment transactions ("Transactions"), described more fully below, that Investor has made directly and through the use of options.

I. Summary of the Transactions

A. Fund

AD Equity Fund 2000 LLC, is a domestic limited liability company that we have assumed has not and will not elect to be treated as a corporation for U.S. federal income tax purposes ("Fund"). Fund was formed for the purpose of acquiring financial investments, buying and selling options on equity securities, and conducting other investment activities. Fund initially had two members, Alpha Consultants, Inc., a domestic corporation ("Alpha")[1] and The Diversified Group Incorporated, a domestic corporation, ("DGI"). Alpha and DGI were both Managers of Fund. (Alpha and DGI are hereinafter collectively referred to as the "Managers".)

B. Investment in Equity Options

On November 9, 2000, Investor through, JXS Trading LLC ("SMLLC"), a domestic limited liability company of which Investor is the sole member, entered into two over-the-counter, non-publicly traded equity option transactions with an independent financial institution ("Bank").[2] The first was the purchase of a European-style cash-settled digital call option having

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1 Based on materials provided by the Managers, Alpha was formed in 1999. Prior to forming Alpha, principals of Alpha were portfolio managers of hedge funds having approximately $30 billion in assets.

2 As discussed in the text below, it is more likely than not that SMLLC would be disregarded as an entity

a 71 day term, reference number 2000-11-09-02, for a premium of $25,000,000 ("Long Option"). The second was the sale of a European-style cash-settled digital call option, having a 71 day term, reference number 2000-11-09-01, for a premium of $24,500,000 ("Short Option"). (The forgoing transactions are hereinafter individually referred as an "Option" and collectively as the "Options".) The aggregate net cost to Investor from entering into the Options was $500,000. Investor paid an aggregate investment advisory fee of $750,000 in connection with the transactions described herein.

Managers have advised us in connection with rendering this opinion that although the Options by their terms did not provide for transferability, it was and is common market practice for options such as the Options to be sold or otherwise transferred separately from each other (subject to satisfying the Bank's credit requirements).

C. Contribution to Fund

On November 15, 2000, Investor contributed all of Investor's membership interest in SMLLC to Fund in exchange for a 87.72% interest in Fund. We have been advised by the Managers that at the time of such contribution (i) the net value of the Options, SMLLC's only assets, was $291,405, and (ii) the Short Option was out of the money.

D. Fund Investments

In addition to the Options owned by SMLLC, Fund entered into a series of similar investment transactions.

E. Withdrawal from Fund

On December 20, 2000, Investor withdrew from Fund. In exchange for its membership interest Investor received shares of publicly traded stock ("Financial Assets") and $2,179. We have been advised by the Managers that an aggregate fair market value of distribution at the time of resignation was $31,249 and such amounts equaled the fair market value of Investor's membership interest in Fund.

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separate from Investor or, (after its transfer to Fund) Fund, for U.S. federal income tax purposes. Consequently, except to the extent SMLLC is specifically referred to herein, all references to Investor prior to the transfer of SMLLC to Fund, or to Fund following the transfer SMLLC to Fund, will encompass SMLLC.

Managers have advised that following the withdrawal of Investor, Fund remained in existence and continued its investment activities.

F. Subsequent Events

We understand that Investor sold the financial assets Investor had received upon Investor's withdrawal from Fund for their then fair market value.

II. Representations:

A. Investor Representations:

For purpose of rendering our opinion, Investor has represented as follows:

1. Investor entered into the Options for substantial non-tax business reasons, including to produce an overall economic profit from the movement of the equities referenced by the Options.

2. Based upon Investor's own independent evaluation and upon the advice of Managers, Investor believed that by entering into the Options Investor could significantly leverage Investor's investment in such equity index.

3. Based upon advice of the Managers as to the probability of the referenced equities reaching certain levels at which the Options would be profitable, and upon Investor's own independent evaluation, Investor believed that Investor had a reasonable opportunity to earn a reasonable profit, in excess of all fees and transaction costs, from the Transactions, without regard to tax benefits.

4. Based on the advice of Managers, and upon Investor's own independent evaluation, Investor had an opportunity to make an aggregate gross return in excess of the sum of Investor's net investment in the Options and the Advisory Fee paid by Investor.

5. Investor contributed the membership interest in SMLLC to Fund for substantial non-tax business reasons, including diversification of Investor's portfolio without the need for additional investment, the professional management provided by the Managers, and the desire to create larger pool of capital through the involvement of other investors such as the Managers.

6. SMLLC has not elected under Treas. Reg. §301.7701-3 to be classified as a corporation.

7. Investor has not hedged Investor's risks with respect to the Options with Bank.

8. Investor has not identified, and will not identify, any of the Options as being part of a hedging transaction under Treas. Reg.§1.446-4.

9. The Financial Assets received by Investor upon Investor's withdrawal from Fund are capital assets in Investor's hands and in the hands of Corp.

10. Investor is not related to the other members of Fund.

11. Whether and when Investor terminated Investor's investment in Fund was within Investor's sole discretion and control.

12. There existed no understanding, agreement, obligation, or arrangement pursuant to which any of the parties described herein committed to undertake all or any of the transactions described herein upon the happening of any other transaction, except to the extent that Investor/SMLLC (and Fund as transferee of Investor) and Bank were contractually obligated to perform under the Options in accordance with their stated terms.

13. Investor has not entered into a confidentiality agreement or otherwise agreed (orally or in writing) to any obligations of confidentiality with respect to the Transactions.

14. Investor owns 100% of the issued and outstanding stock of Corp.

15. At the time of the contribution of the Financial Assets to Corp the Financial Assets were not subject to any liabilities, and Corp assumed no liabilities and distributed or paid no money or other property to Investor in connection with such contribution.

16. Corp has elected to be treated as an S corporation for U.S. federal income tax purposes.

17. Investor actively participates in the management of Corp's activities.

18. Investor has reviewed the description of the Transactions as set forth herein and such description is accurate and complete, and there are no pertinent facts relating to the Transactions that have not been set forth in such description.

B. **<u>Fund Representations</u>:**

For purpose of rendering our opinion, Fund has represented as follows:

1. Fund has not hedged its risks with respect to the Options with Bank.

2. Fund has not identified, and will not identify, any of the Options as being part of a hedging transaction under Treas. Reg.§1.446-4.

3. Fund will determine its members' distributive shares income, gain, loss, deduction, or credit and will maintain its members' capital accounts in accordance with Code Section 704 and the Treasury Regulations promulgated thereunder.

4. Fund has not made an election under Code Section 754 and will not do so for the taxable year or years in which the Transactions occur.

5. Fund has not elected, and will not elect, under Treas. Reg. §301.7701-3 to be classified as a corporation.

6. Fund entered into the Transactions for substantial non-tax business reasons, including to produce an overall profit from its investments in equities and equity options.

7. Based upon the advice of Managers, (x) the Options are not listed on or subject to the rules of a qualified board or exchange as those terms are used in Code Section 1256(g)(5).

8. Fund has not and will not caused SMLLC to elect under Treas. Reg. §301.7701-3 to be classified as a corporation.

III. Conclusions

In rendering our opinions, we have reviewed representations and advice, including financial information, from various parties to the Transactions and made certain assumptions, which representations, advice and assumptions are referred to below. In rendering our opinions, we have also examined such agreements, certificates, instruments and documents, and we have made such other inquires of officers, owners and representatives of the entities involved in the Transactions as we have considered necessary to render the opinions set forth herein. We have made no independent verification of such representations, advice, assumptions, records, agreements, certificates, instruments, documents, and responses to such inquiries. If any such representations, advice, assumptions, records, agreements, certificates, instruments, documents, or responses is inaccurate in any material respect, or any such agreements, certificates, instruments, and documents prove not to be authentic, the opinions contained herein may not be

relied upon. In rendering our opinion, we have reviewed the applicable provisions of the Code and of the final, temporary, and proposed Treasury Regulations ("Treas. Reg.", "Treasury Regulations", or "Regulations") promulgated thereunder; relevant decisions of the U.S. federal courts; published Revenue Rulings ("Rev. Rul.") and Revenue Procedures ("Rev. Proc.") of the Internal Revenue Service ("IRS"); and such other materials as we have considered relevant. In certain instances we have determined that there is no authority directly on point, and in such instances we have reached our opinion reasoning from such other authority as we believe to be relevant to the issues addressed.

Although we are not representing DGI in connection with the Transactions, in the past we have represented DGI and persons affiliated with DGI with respect to certain matters and may continue to do so in the future. You have agreed to waive any legal conflict that may arise from such past or future representation.

Based on and subject to the summary set out at Section I above and the analysis of the pertinent statutory provisions and legal doctrines at Section IV below, as of the date hereof:

(a) We are of the opinion that for U.S. federal income tax purposes it is more likely than not that:

(i) SMLLC would be disregarded as an entity separate from Investor.

(ii) Fund would be classified as a partnership.

(iii) The Options would be treated as separate instruments.

(iv) The Options would not be subject to the timing rules of Treas. Reg. 1.446-4.

(v) The Options would not be section 1256 contracts.

(vi) Investor's tax basis in the Long Option transferred to Fund would equal the premium paid to Bank with respect thereto and any other costs associated with acquiring such option.

(vii) Investor would not recognize material taxable gain or any taxable loss upon the assignment of the Options to Fund.

(viii) The Short Option would not be considered a liability for purposes of Code Section 752.

(ix) Investor's basis in Investor's membership interest in Fund would be equal to Investor's basis in the Long Option, reduced by the amount of liabilities as determined for purposes of Code Section 752 assumed by Fund and increased by Investor's share of such liabilities and the amount of the Advisory Fee paid by Investor.

(x) Investor would not recognize gain or loss on the receipt of a distribution of Financial Assets and cash from Fund in exchange for Investor's membership interest in Fund.

(xi) Investor would not recognize gain or loss on the receipt of a distribution of Financial Assets and any cash from Fund in exchange for Investor's membership interest in Fund.

(xii) Upon redemption of Investor's interest in the Fund, Investor's adjusted basis in its Fund interest immediately before such distribution, reduced by the amount of any money distributed to Investor in the redemption, will be allocated between the Financial Assets distributed to Investor in the redemption.

(xiii) The contribution by Investor of the Financial Assets to Corp would qualify as an exchange described in Code Section 351(a) on which Investor would recognize no gain or loss.

(xiv) Investor's tax basis in Investor's Corp stock is increased by the amount of Investor's tax basis in the contributed Financial Assets.

(xv) Corp's basis in Investor's interest in the Financial Assets would equal Investor's tax basis therein.

(xvi) Gain or loss recognized by Corp upon the disposition of Financial Assets distributed to Investor in the redemption will be characterized as a capital gain or loss.

(xvii) With respect to the application of certain loss limitation rules potentially affecting the deductibility of any loss claimed by Investor in connection with the Transactions:

a. The sham transaction doctrine would not apply and, based on the representations of Investor, the Transactions would have the requisite business purpose and economic substance;

b. Although the matter cannot be entirely free from doubt because of the factual nature of the inquiry, on balance, the requisite profit

motive exists to support the deduction of any loss from the Transactions under Code Section 165(c)(2);

c. The step transaction doctrine would not apply to the Transactions;

d. The contribution of the Options and the subsequent liquidating distribution to Investor would not be treated as a sale under Code Section 707;

e. The IRS would be unsuccessful were it either to assert under Treas. Reg. §1.701-2 that the Transactions are inconsistent with the intent of subchapter K or to assert that Fund should be disregarded entirely under Treas. Reg. §1.701-2 or under common law principles;

f. Any losses incurred by Investor from the transferred Options or Investor's investment in Fund would not be limited by Code Section 1092;

g. Any losses from the Transactions would not be limited by Code Section 1366(d);

h. Any loss that Investor incurs from the Transactions would not be limited by the Code Section 465 "at risk" rules;

i. Any loss that Investor incurs from the Transactions would not be subject to the limitations under Code Section 469;

j. Code Section 269 would not be applicable; and

k. Code Section 482 would not be applicable to the Transactions.

(b) Based upon the foregoing, there is a greater than 50 percent likelihood that the tax treatment of the Transactions would be upheld if challenged by the IRS.

(c) Based upon the foregoing, the IRS should not be successful were it to assert a penalty against Investor under Code Section 6662(b)(2) or (3) for positions taken on Investor's U.S. federal income tax return with respect to the Transactions.

(d) It is more likely than not that the Transactions would not constitute a tax shelter within the meaning of Code Section 6111(c)(1) and, therefore, would not be required to be registered under Code Section 6111(a).

We wish to point out that our opinion is not binding upon the IRS or a court of law.

IV. Analysis

A. SMLLC Disregarded

Treas. Reg. §301.7701-2(b)(1)-(8) describes certain entities that are classified as corporations for U.S. federal income tax purposes. Treas. Reg. §301.7701-3 provides that an entity not described in Treas. Reg. §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) is considered to be an "eligible entity", which may elect to be classified as a corporation or, if it has a single owner, be disregarded as an entity separate from its owner. Treas. Reg. §301.7701-(3)(b)(1) provides that a domestic eligible entity that has a single owner and does not elect to be classified as a corporation would be disregarded as an entity separate from its own for U.S. federal income tax purposes.

Based on the facts set forth above, SMLLC will constitute a domestic eligible entity. Consequently, if, SMLLC does not elect to be classified as a corporation, it is more likely than not that SMLLC will be disregarded as an entity separate from Investor or (after its contributions to Fund) Fund, for U.S. federal income tax purposes.

B. Fund is Treated as a Partnership

Treas. Reg. §301.7701-2(b)(1)-(8) describes certain entities that are classified as corporations for U.S. federal tax purposes. Treas. Reg. §301.7701-3 provides that an entity not described in Treas. Reg. §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) is considered to be an "eligible entity", which may elect to be classified as either a corporation or, if it has 2 or more owners, a partnership. Treas. Reg. §301.7701-(3)(b)(1) provides that a domestic eligible entity that has two or more members and does not elect to be classified as a corporation will be classified as a partnership for U.S. federal income tax purposes.

Based on the facts set forth above, it is more likely than not that Fund would constitute a domestic eligible entity. Consequently, if Fund, as represented, has not elected and does not elect to be classified as a corporation, it is more likely than not that Fund would be treated as a partnership for U.S. federal income tax purposes.[3]

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[3] Fund has represented that Fund will determine its members' distributive shares income, gain, loss, deduction, or credit and will maintain its members' capital accountants in accordance with Code Section 704 and the Treasury Regulations promulgated thereunder. As a result, on liquidation of Fund or a

Under common law the courts have held that a partnership is respected for tax purposes if the parties join together to jointly conduct a business and share the profits. See, e.g., Comm'r v. Culbertson, 337 U.S. 733 (1949). In Comm'r v. Culbertson, supra, at 741, the Court stated that whether a partnership existed for tax purposes depends on "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both."

In PLR 9914006 (12/23/98), a limited liability company ("LLC") was owned by a partnership and a corporation, all of the stock of which was owned by the partnership. Under the LLC agreement, the corporation was not entitled to receive any distributions, and did not receive any allocations of income, gain, profit, loss, deduction, credit, or other amount from the LLC. One of the issues in the ruling was whether the LLC was a partnership for tax purposes. The IRS cited Culbertson, supra, and Comm'r v. Tower, 327 U.S. 280 (1946) for the general principles applicable to determine whether a partnership exists. The ruling states that "The primary inquiry

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member's interest therein, such capital account will affect the amount such member will receive. It should be noted that a partner's basis in his or her partnership interest and the partner's capital account in the partnership are not necessarily the same. See, Willis, Pennel, Postlewaite, Partnership Taxation, Vol. 1, ¶5.02 (6th Ed. 1997). See also, Treas. Reg. §1.704-1(b)(2)(iv)(g)(1), which reflects this rationale.

Establishment and maintenance of a partnership's capital accounts is governed by the rules of Treas. Reg. §1.704-1(b)(2)(iv). Treas. Reg. §1.704-1(b)(2)(iv)(b)(2) provides that a partner's capital account is increased by "the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752)". Treas. Reg. §1.704-1(b)(2)(iv)(h) provides:

> For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership.... will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. Valuation of property contributed to the partnership... shall be on a property-by-property basis....

Consequently, we have been advised that Investor's initial capital account in Fund equaled the net value of the Options contributed to Fund and this fully reflected the amount that Investor received on liquidation of Fund or his interest therein reflected this amount.

Although the Short Option is not a liability, its acceptance by Fund represents the assumption by Fund of an economic undertaking. In that regard it is analogous to assuming a Code Section 752 liability and treating it in the same manner as such a liability for capital account purposes is consistent with establishing a capital account for Investor that reflects Investor's economic interest in the partnership. Lastly, nothing in Treas. Reg. §1.704-1(b)(2)(iv)(h) would appear to prevent the partners from agreeing to a negative value for such an undertaking if in fact that item reflects a potential economic cost to the partnership. Such an approach appears to be consistent with the revaluation rules of Treas. Reg. §1.704-1(b)(2)(iv)(f) and the book value adjustment rules of Treas. Reg. §1.704-1(b)(2)(iv)(g).

is whether the parties intended to join together to operate a business and share in its profits and losses." Because the corporation in the ruling had no interest in the profits and losses of the LLC, the IRS concluded that the corporation was not a partner, and that therefore the partnership was the sole owner of the LLC so that the LLC was disregarded for tax purposes. Thus, the critical issue in this ruling was whether the purported partners joined together to conduct a business and share the profits and losses. In the present situation, Investor and the other members invested in Fund with the intent of jointly conducting an activity (investing) and sharing the profits and losses therefrom, and this is reflected in the terms of the Fund's organizational documents.

In ASA Investerings Partnership v. Comm'r, T.C. Memo. 1998-305, aff'd 201 F.3d 505 (D.C. Cir. 2000), the court found that a partnership formed by Allied Signal and ABN, a foreign partner, was not a valid partnership arrangement for U.S. federal income tax purposes. The court based its holding, in part, on what it viewed as the two party's different investment objectives. In the court's view, Allied Signal only wanted the capital losses while ABN was only interested in earning a specified rate of return on its investment. ABN did not want to share in any losses. The court found that Allied Signal was obligated to pay all expenses and guarantee ABN a minimum profit and made all the critical management decisions. As a result, the court concluded that ABN was not a partner in a partnership, but rather was a mere lender. The court noted that Allied Signal agreed to enter into the transaction before it even knew that ABN would be involved.

The **Allied Signal** case is distinguishable from the Transactions in several key respects. Each member invested in Fund in anticipation of realizing profits from Fund's investment activities. Investor and the other members all have the potential for profit or loss in respect of their collective investment in Fund. No member was guaranteed a particular minimum profit. Each member shares proportionately in the income, gain, loss and deductions of Fund, so that there is no issue of recharacterization as in the Allied Signal case.

Based upon the foregoing, it is more likely than not that Fund would be treated as a partnership under the common law principles contained in these cases.

C. The Options

1. Taxation of Options Generally

The tax consequences of the issuance of an option are set out not in the Code, but in cases and Rulings. The fundamental case regarding the timing of income arising from an option is Virginia Iron Coal & Coke Co. v. Comm'r, 37 B.T.A. 195 (1938), a reviewed decision. In case that the taxpayer granted Texas Gulf Sulphur Co. ("TGS") a four-year option to buy stock of a subsidiary in exchange for a one-time payment of $300,000 in 1930 and annual payments of $125,000. The payments were to be applied to the purchase price if TGS exercised the option. After paying $300,000 in 1930 and $125,000 in 1931, in 1933 TGS notified the taxpayer that TGS was abandoning the option. The taxpayer, who had not initially reported the receipt of the option premiums, thereupon filed amended returns for 1930 and 1931 reporting the premiums as income in the year received. The Commissioner asserted that the premiums were income in the year the option was abandoned, and the court agreed, adopting an "open transaction" approach:

> It was impossible to tell in 1930 and 1931, when the payments were received, whether they would ultimately represent income to the petitioner or a return of capital. They were to be applied against the purchase price in case of the exercise of the option. Had the option been exercised, they would have represented a return of capital, that is, a recovery of a part of the basis for gain or loss which the property had in the hands of the seller. In that event they would not have been income and their return as income when received would have been improper. . . [citations omitted]. But in case of termination of the option and abandonment by the Texas Co. of its right to have the payments applied as a part of the purchase price, it would be apparent for the first time that the payments represented clear gain to the petitioner. In that case, since no property would be sold, there would be no reason to reduce the basis of that retained.
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> Thus it was impossible for either the taxpayer or the Commissioner to determine in 1930 and 1931 whether or not the payments would eventually represent income and how they should be reported. Obviously those years could not be held open for income tax purposes to await the final outcome of such contracts. The taxpayer in this case, after the option to purchase had been surrendered, filed amended returns reporting the payments as income for the years in which received. But returns must be filed

> in the light of facts known at the time the returns are due. Some other taxpayer might not choose to file amended returns. Then the statute of limitations would foreclose the Commissioner and prevent the collection of taxes lawfully due. If the Commissioner is to make an orderly and uniform collection of taxes in such cases, the tax liability for those earlier years must be determined and closed by collection, without waiting to see whether or not the option is exercised.
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> *Thus it is necessary to exclude such payments from the income of the year in which received and to include them for the later year when, for the first time, a satisfactory determination of their character for income tax purposes can be made.* The other party to the contract in the taxable year for the first time released and abandoned its right under the agreements to have the payments applied against the purchase price, and charged off its loss. The recipient then knew for the first time that it could retain the payments without any obligation to apply them against the purchase price. Its property was then free of the option. It had lost nothing, but had retained everything with which it started and had acquired $425,000 in addition. The $425,000 was then income.
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> The taxpayer argues that, since the funds were received in 1930 and 1931 with the right to retain them forever and to use them without restriction, they should have been accrued as income for those years. *Although they were received without any obligation to return them, there was one condition attached to their receipt. That is, they had to be applied against the purchase price in case the option was exercised.* That one condition is the determining factor in this case. Until it was removed in 1933, the question of the liability of the recipient for income tax upon the payments had to be held in abeyance. [Emphasis added]

37 B.T.A. 197-199. A dissent argued that the taxpayer recognized income in the year of receipt because it had unfettered control of the premium at that time. The dissent added that the income could be included in the year the option was abandoned under only one of two theories, both of which the dissent felt were untenable. The first theory is that TGS "forfeited" the premiums only in 1933. That theory was untenable because the taxpayer had absolute control of the funds since 1930, so TGS had nothing to "forfeit". The second theory was that the value of the abandonment was income. However, if that were the case, the only income would be the difference between

the value of the optioned property at the time of the abandonment and the price at which the taxpayer was obligated to convey it.

The rationale of the Virginia Iron Coal case, that the receipt of an option premium is not income, has continually been accepted by the IRS. The first holding of I. T. 3835, 1947-1 C. B. 53, states that the premium received by the writer (issuer or optionor) of a put or call option which is not exercised constitutes a short-term capital gain, under section 117(g)(2) of the Internal Revenue Code of 1939, to be taken into account in computing his gross income, for federal income tax purposes, only for the taxable year in which the failure to exercise the option became final. Rev. Rul. 58-234, 1958-1 C.B. 279, notes that section 117(g)(2) of the Internal Revenue Code of 1939 specifically provided that "gains ... attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains ...", although the Internal Revenue Code of 1954 contained no provision treating such gains as capital gain, either short-term or long-term. Therefore, the IRS held that the premium received by the writer of a put or call option which is not exercised constitutes ordinary income under section 61 of the 1954 Code, to be included in his gross income only for the taxable year in which the failure to exercise the option becomes final. Like the court in The Virginia Iron Coal case, the IRS used an "open transaction" approach:

> An optionor, by the mere granting of an option to sell ("put"), or buy ("call"), certain property, may not have parted with any physical or tangible assets; but, just as the optionee thereby acquires a right to sell, or buy, certain property at a fixed price during a specified future period or on or before a specified future date, so does the optionor become obligated to accept, or deliver, such property at that price, if the option is exercised. Since the optionor assumes such obligation, which may be burdensome and is continuing until the option is terminated, without exercise, or otherwise, there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option. The open, rather than closed, status of an unexercised and otherwise unterminated option to buy (in effect a "call") was recognized, for federal income tax purposes, in A.E. Hollingsworth v. Comm'r, 27 B.T.A. 621, acquiescence, C. B. XII-1, 6 (1933). It is manifest, from the nature and consequences of "put" or "call" option premiums and obligations, that there is no federal income tax incidence on account of either the receipt or the payment of such option premiums, i.e., from the standpoint of

> either the optionor or the optionee, unless and until the options have been terminated, by failure to exercise, or otherwise, with resultant gain or loss. The optionor, seeking to minimize or conclude the eventual burden of his option obligation, might pay the optionee, as consideration for cancellation of the option, an amount equal to or greater than the premium. Hence, no income, gain, profits, or earnings are derived from the receipt of either a "put" or "call" option premium unless and until the option expires without being exercised, or is terminated upon payment by the optionor of an amount less than the premium. Therefore, it is considered that the principle of the decision in North American Oil Consolidated v. Burnet, 286 U.S. 417, Ct. D. 499, C. B. XI-1, 293 (1932), which involved the receipt of "earnings," is not applicable to receipts of premiums on outstanding options.

Rev. Rul. 78-182, 1978-1 C.B. 265, which deals with options on the Chicago Board Options Exchange, follows Rev. Rul. 58-234 in holding, inter alia, that as to the writer of a put or call, "there is no federal income tax incident on account of either the receipt or the payment of such option premium, that is, from the standpoint of either the optionor or the optionee, unless and until the options have been terminated, by failure to exercise, or otherwise, with resultant gain or loss." As discussed below, PLR 8038087, infra, PLR 7938018, infra, and PLR 8113024 hold that the assumption of a warrant in a corporate reorganization is not an event that would trigger such gain. Furthermore, in the instant case, SMLLC continually remains the counterparty of Bank with respect to the Options until their termination. As a result, the legal relationship of the optionor and optionee remain unchanged throughout the Transactions until the Options terminate.

Based on the foregoing, it is more likely than not hold than no income or loss would be recognized with respect to an Option at the time Option was entered into. Furthermore, as discussed below, it is more likely than not that any income or loss arising from the termination of an Option would be treated as income or loss of Fund, the then owner of the Option, and would not be directly attributed to Investor.

2. The Options as Separate Instruments

In determining the U.S. federal income tax consequences of the Transactions, it must be determined whether the Long Option and the Short Option would be treated as separate instruments or the Options would be integrated in some way.

Each Option may be transferred or assigned independently, an important factor in determining if two instruments should be treated as one. For example, Congress needed to add Code Section 269B to the Code to provide special rules for the treatment of a stapled entity. A stapled entity is one where the stock of one entity cannot be traded without trading the stock of the other entity. The legislative history of this provision indicates that the law in this regard was unclear. Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, 98th Cong., 2d Sess., 454 (1984). We are not aware of any efforts by Congress to treat non-stapled entities as a single entity.

Further, Investor and Bank, and Fund and Bank, retain real net economic risk which they will not hedge with each other. As discussed below, it is more likely than not that Treas. Reg. §1.446-4 would not apply to the Options. Even if these Regulations were to apply, however, there is nothing in them that would cause the Options to be integrated.

In addition, Congress has recognized that separate instruments are generally given separate effect, even when one transaction may significantly offset the risk of the other. See, e.g., Code Section 1092 (loss on one position of a straddle is deferred until gain is recognized on the offsetting position; the offsetting positions are not netted); Code Section 1258 (recharacterizing certain gain attributable to the time value of a taxpayer's investment as ordinary income, not purporting to recharacterize the transaction as a borrowing) and Code Section 1259 (constructive sale provision).

Finally, case law recognizes that a taxpayer can hold long and short positions in property at the same time, and that each position is a separate property. In Smith v. Comm'r, 78 T.C. 350 (1982), the court held that each leg of a straddle should be treated as separate property, whether the legs were acquired at different times or at the same time. See also, Stoller v. Comm'r, 994 F.2d 855 (DC Cir. 1993), aff'g in part and rev'g in part, 60 TCM (CCH) 1554 (1990) (separate contracts were respected); Richardson v. Comm'r, 121 F.2d 1 (2d Cir. 1941) (can hold long and short positions at the same time). See also, Rev. Proc. 65-29, 1965-2 C.B. 1023; Rev. Rul. 78-182, supra; Arnall v. U.S., a District Court case unofficially reported at 59-2 USTC ¶9779 (N.D. Ga. 1959).

Consequently, based on the foregoing, it is more likely than not that the Options would be treated as separate instruments.

3. Tax Basis in the Long Option

In Rev. Rul. 78-182, supra, the IRS concluded that the tax basis of the purchaser of a put or a call option with respect to certain stock was the premium paid for the option plus any fees or other costs associated with acquiring the options. The position taken by the IRS in Rev. Rul.78-182 should be equally applicable in the instant case. Consequently, it is more likely than not that Investor's tax basis in the Long Option would equal the premium paid to Bank with respect thereto and any other costs associated with acquiring such option.

4. Treas. Reg. §1.446-4 is Inapplicable

Treas. Reg. §1.446-4 provides that the timing of income, gains, deduction and losses from a hedging transaction as defined in Treas. Reg. §1.1221-2(b)(1) match those of the hedged transaction. Treas. Reg. §1.1221-2(f) provides, with two exceptions, that the absence of a proper identification of a transaction as a hedging transaction establishes that the transaction is not a hedging transaction. The exceptions are (i) for inadvertent error (ii) an anti-abuse rule which provides, in appropriate circumstances, not that the transaction is a hedging transaction but that gain from the transaction is ordinary. Based upon the representations contained in II, above, neither Fund nor Investor has identified or will identify the Options as being part of a hedging transaction. Consequently then it is more likely than not that the matching rule of Treas. Reg. §1.446-4 will not apply.

5. The Options are not Section 1256 Contracts

Code Section 1256(a) requires mark-to-market treatment for a "section 1256 contract" held by a taxpayer at the close of the taxpayer's taxable year and upon the termination or transfer of a taxpayer's rights or obligations with respect to such a contract during the year by assignment, lapse, or otherwise. This is achieved by treating each such contract held by the taxpayer as sold on such date for the contract's fair market value. Code Section 1256(a)(1). Code Section 1256(a)(2) provides that "proper adjustment shall be made in the amount of gain or loss subsequently realized for gain or loss taken into account by reason of such paragraph (1)."

Code Section 1256(b) defines a section 1256 contract as (i) a regulated futures contract within the meaning of Code Section 1256(g)(1), (ii) a foreign currency contract within the meaning of Code Section 1256(g)(2), (iii) a nonequity option within the meaning of Code

Section 1256(g)(3), and (iv) a dealer equity option within the meaning of Code Section 1256(g)(4).

A futures contract is not defined in Code Section 1256. However, the Commodities Future Trading Commission ("CFTC") has defined a futures contract as:

> [A]n agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at the initiation of the contract; (2) *which obligates each party to the contract* to fulfill the contract at the specified price; (3) which is used to assume or shift price risk; and (4) which may be satisfied by delivery or offset. [emphasis added]

See, CFTC Glossary: A Layman's Guide to the Language of the Futures Industry. Because an option is conditional, each party to the contract is not so obligated. As a result, it is more likely than not that the Options would not be treated as futures contracts for purposes of Code Section 1256. Furthermore, even if the Options constituted futures contracts, over-the-counter futures contracts between two private parties, such as the Options, are not "regulated futures contracts" within the meaning of Code Section 1256(g)(1). See, Rev. Rul. 87-43, 1987-1 C.B. 252. Consequently, it is more likely than not that the Options would not constitute regulated futures contracts within the meaning of Code Section 1256(g)(1).

Code Section 1256(g)(3) defines a nonequity option as any listed option, within the meaning of Code Section 1256 (g)(5), that is not an equity option. Code Section 1256(g)(6) defines an equity option as an option to buy or sell stock or an option the value of which is directly or indirectly determined by reference to one or more stocks or a stock index. It is more likely than not that the Options would be equity options under this definition. Furthermore, Code Section 1256(g)(5) defines a listed option as any option listed on, or subject to the rules of, a qualified board or exchange. Code Section 1256(g)(7) defines a qualified board or exchange as a national securities exchange that is registered with the SEC; a domestic board of trade designated as a contract market by the CFTC; or any other exchange, board of trade or other market that the Treasury determines has certain rules. In the instant case, the Options are not listed on a CFTC-designated contract market. Consequently, it is more likely than not that the Options are not listed options within the meaning of Code Section 1256(g)(5).

Code Section 1256(g)(4) defines a dealer equity option as, among other things, a listed option. As discussed above, it is more likely than not that the Options are not listed options.

Therefore, it is more likely than not that the Options would not be dealer equity options within the meaning of Code Section 1256(g)(4).

Lastly, Code Section 1256(g)(2)(A) defines a foreign currency contract to mean a contract that (i) settles in or with reference to a currency in which positions are traded through regulated futures contracts; (ii) is traded in the interbank market; and (iii) is entered into at an arm's length price determined by reference to the price in such market. Given the terms of the Options, it is more likely than not that the Options are not foreign currency contracts.

Based on the foregoing, it is more likely than not that the Options would not constitute section 1256 contracts subject to the mark-to-market rules of Code Section 1256.

Were the Options section 1256 contracts that were subject to the mark-to-market rules, the transfer of the of the Options to the Fund would require Investor to recognize any gain or loss that arose with respect to each of the Options from the time the Options were acquired to the date of such transfer. Because the period of time that Investor held the Options was very short, it is not anticipated that any such gain or loss would be material. Were the Options section 1256 contracts that were subject to the mark-to-market rules upon their transfer to Fund, it is possible that the IRS might contend that the transfer should be treated either (i) as if Investor sold the Options to Fund or (ii) as if Investor closed Investor's position in the Options and Fund entered into "new" Options having the same terms. Were the IRS successful in making such contention, the transfer of the Options to Fund would not be subject to the rules regarding contributions to a partnership as discussed below. We believe that it is more likely than not that the IRS would not be successful were it to so contend.

The purpose of enacting Code Section 1256 as part of the Economic Recovery Act of 1981 ("1981 Act") was to conform the tax treatment of regulated futures contracts to the daily cash settlement, mark-to-market system employed by U.S. commodity futures exchanges for purposes of determining margin requirements. Under this system, even though a trader does not close out a position, but continues to hold it, the trader receives any gain in the position in cash as a matter if right each trading day and the trader has the right to withdraw such amount. Correspondingly, if the position declines in value, the trader is required to deposit additional funds. Thus, Congress intended Code Section 1256 to apply the doctrine of "constructive receipt" to the economic gains or losses realized by the taxpayer at year end even though the taxpayer continued to hold such positions. See, General Explanation of the Economic Recovery

Act of 1981 (H.R. 4242, 97th Cong., P.L. 97-34) prepared by the Staff of the Joint Committee on Taxation (12/31/81) ("1981 General Explanation") at 296. In Murphy v. U.S., 992 F.2d 929 (9th Cir. 1991), aff'g an unreported District Court decision, the court concluded that Code Section 1256 was constitutional because Congress premised recognition of gain or loss under Code Section 1256 on the existing doctrine of constructive receipt.

The 1981 General Explanation also provides:

> If a taxpayer holds futures contracts at the beginning of a taxable year, any gain or loss subsequently realized *on these contracts* must be adjusted to reflect any gain or loss taken into account *with respect to these contracts* in a prior year.

Although Congress could just as easily provide that the mark-to-market rules created a constructive sale and repurchase of the contracts to adjust the basis of the contracts to reflect the gains and losses triggered under Code Section 1256(a)(1), it did not do so. Rather it chose to apply constructive receipt principles to merely trigger mark-to-market gain or loss with respect to a contract at a particular point in time and to adjust the amount of subsequent gain or loss with respect to such contract by reference to such previously recognized gain or loss.

Code Section 1256(a) as enacted pursuant to the 1981 Act applied only to contracts held by a taxpayer at year-end and did not address events occurring within the year, such as a termination or transfer of a contract. To do so, Congress added Code Section 1256(c) as part of the Technical Corrections Act of 1982 ('1982 Act"). Code Section 1256(c) provides relevant part:

> (1) IN GENERAL. The rules of paragraphs (1) [income and loss recognition], (2) [proper adjustment], and (3) [character] of subsection (a) shall also apply to the termination (or transfer) during the taxable year of the taxpayer's obligation (or rights) with respect to a section 1256 contract by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, or otherwise.

In enacting Code Section 1256(c)(1) Congress clearly intended the rules of Code Section 1256(a)(1), (2), and (3) to apply to transfers to by a partner to a partnership. See, JCS-20-82, Description of H.R. 6056, Technical Corrections Act of 1982, prepared for Use by the

Committee for Ways and Means for a Hearing on April 27, 1982 by the Staff of the Joint Committee on Taxation ("Description"). At page 3, the Description provides:

> The bill would require expressly that gains and losses be taken into account when a taxpayer's rights in a regulated futures contract are transferred. Thus, section 1256(a) would apply when transfers of regulated futures contracts are made to and from partnerships and other flow through entities.

Although the legislation could have provided that a transfer to a partnership (or other flow through entity) would be deemed to be a sale by the partner to the partnership or the termination of the contract by the partner and the entering into of a "new" contract by the partnership, it did not do so. Rather, it merely required that such a transfer trigger the mark-to-market gain recognition and other rules of Code Section 1256(a).

Based on the foregoing, it is more likely than not that the application of Code Section 1256(a)(1) upon the transfer of the Options by Investor to Fund would not cause Investor to be treated either (i) as selling the Options to Fund or (ii) as closing Investor's position in the Options and Fund entering into "new" Options having the same terms, and that the transfer of the Options to Fund would be subject to the rules regarding contributions to a partnership, as discussed below and a Code Section 1256(a)(2) "proper adjustment" would be made with respect to any subsequent gain or loss recognized by Fund with respect to the contributed Options.

D. Contribution of the Options to Fund

1. Nonrecognition of Income

(a) General Rule

Code Section 721(a) and Treas. Reg. §1.721-1 generally provide that no gain or loss is recognized by either the partnership or any partner in the case of a contribution of property to the partnership in exchange for a partnership interest. Although the term "property" is not defined in subchapter K of the Code, its common meaning implies that to be property an asset or right must involve some potential economic return (even if that return would not generate a profit). For example in Dillon v. U.S., an unreported District Court case unofficially reported at 84-2 USTC ¶9921 (S.D. Tex, 1981), the court held that a contractual right to participate as a partner in a second partnership constituted property contributed to the first

partnership for purposes of Code Section 721. Furthermore, although neither the Code nor the Regulations defines the term "property" under Code Section 721, that Section is similar to Code Section 351 in the corporate context, where the term "property" is given a broad interpretation, and serves to distinguish services from property. See also, Stafford v. U.S., 611 F.2d 990 (5th Cir. 1980); PLR 8225069 (3/24/82). Consequently, it is more likely than not that the Long Option would qualify as property for purposes of Code Section 721 and that Code Section 721 would generally apply to the contribution of the Long Option by Investor to Fund.

While the Short Option would, more likely than not, not constitute property under this interpretation, it is more likely than not that Investor would nonetheless not recognize gain or loss on the assignment of the Short Option because (i) Code Section 721(a) applies by its literal terms "in the case of a contribution of property" to a partnership, and the assignment here occurs in conjunction with such a contribution, and (ii) as discussed below, gain or loss is recognized by the grantor of an option only when that option "terminates" in a transaction in which gain or loss would otherwise be recognized, and the assignment of the Short Option to the Fund does not result in its "termination".

(b) Investment Partnership Rules

Notwithstanding that Code Section 721(a) generally provides for nonrecognition of gain or loss upon the contribution of property to a partnership, Code Section 721(b) provides that the nonrecognition rule of Code Section 721(a) does not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company within the meaning of Code Section 351. Thus, gain, but not loss, will be recognized on the contribution of the Long Option to Fund if Fund were an investment company within the meaning of Code Section 351 were it incorporated.

Code Section 351(e) merely provides that gain will be recognized on a transfer of property to an investment company. Treas. Reg. §1.351-1(c)(1) elaborates on this provision by providing that property will be considered transferred to an investment company if:

(i) The transfer results, directly or indirectly, in diversification of the transferors' interests, and

(ii) The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80% of the value of whose assets (excluding cash and

> nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

Treas. Reg. §1.351-1(c)(5) clarifies that diversification occurs if two or more persons transfer nonidentical assets to the corporation, unless these assets are an insignificant portion of the total value of the assets transferred.

The second requirement is that the transferee must be a regulated investment company, a real estate investment trust, or a company more than 80% of the value of whose assets are held for investment. This determination is generally made immediately after the transfer. Treas. Reg. §1.351-1(c)(2).

Code Section 351(e), as amended by the Taxpayer Relief Act of 1997 ("Act"), provides that the determination of whether a company is an investment company is made by taking into account all stock and securities held by the company, and by treating as stock and securities for this purpose, among other things, money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forwards or futures contracts, derivatives, foreign currency, any other asset specified in Treasury Regulations, and equity interests in non-corporate entities that are readily convertible into or exchangeable for such assets. To date, the IRS has not issued any such Regulations.

Based on the expanded definition provide by the Act, it is more likely than not that Fund would qualify as an investment company within the meaning of Code Section 351(e), because its assets consist of cash, stocks and other equity interests in a corporation, evidences of indebtedness, options, forwards or futures contracts, and derivatives. Fund would thus satisfy the asset test. Investor's contribution of the Options will diversify Investor's interests because Investor will share in the other investments of Fund, rather than merely Investor's own equity investments. Consequently, under Code Section 721(b), it is more likely than not that Investor would recognize gain to the extent of appreciation in the value, if any, of the Long Option at the time of its contribution to Fund, but would not recognize any loss with respect to any depreciation in value. Given the fact that the Long Option was contributed to Fund shortly after its acquisition, it is probable that any such gain would not be material and, in any event, under Code Section 722, it is more likely than not any gain recognized would increase Investor's basis in Investor's membership interest in Fund.

(c) Code Section 1234(b)

Code Section 1234(b) provides that gain or loss with respect to any "closing transaction" with respect to an option by the grantor of the option will be treated as short-term capital gain or loss. Code Section 1234(b)(2)(A) was enacted as part of the Tax Reform Act of 1976. According to the legislative history, the purpose of enacting such subsection was to provide uniform character rules to transactions in which a taxpayer recognized income, gain or loss from the lapse or other termination of an option that the taxpayer had granted and thereby eliminate the ability of taxpayers to obtain ordinary loss and capital gain through the use of certain strategies. See, H. Rpt. No. 94-1192, 94th Cong., 2d Sess., 5 (5/26/76) ("TRA Report"). The TRA Report at page 5 stated that the then present law was "based upon several widely publicized private letter rulings issued to the Chicago Board Options Exchange ("CBOE") in which the IRS, among other things, provided that the gain or loss from a closing transaction would be ordinary, even if the options were capital assets and the underlying securities would be capital assets in the hands of the option writer. In those private letter rulings, a closing transaction was described as one in which the grantor or purchaser of a listed option eliminated his or her obligation by purchasing an offsetting listed option and describing the transaction as a closing transaction under the rules of the Exchange.[4] The TRA Report at pages 3 through 5 contemplated that an option writer could terminate his or her obligations under an option in one of three ways: by exercising the option, by letting the option lapse, or by entering into such a closing transaction with respect to the option. As described in the TRA Report at page 4, a closing transaction occurs when the option writer terminates his or her obligation under the option by either reacquiring the option or by making a payment to the options exchange equivalent to the value of an offsetting position. The TRA Report noted, however, that in the case of an over-the-counter option, a writer can only relieve himself of his obligation under the option by repurchasing the specific option that he or she has written (although the writer could hedge his or her position by buying a similar option). In the case of an exchange listed option, the writer could terminate his or her obligation by buying a listed option identical to the one that

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4 Although the legislative history did not cite such private letter rulings, one appears to be 7404080200A. Subsequently, in Rev. Rul. 78-182, supra, the IRS described the U.S. federal income tax treatment of transactions in options traded over the CBOE. The IRS pointed out that if a taxpayer paid an amount equal to the then fair market value of the option and declared the transaction a "closing transaction", under the CBOE rules the taxpayer would be released from liability to settle the closed option. In the Ruling the IRS treated such a 'termination' as a recognition event. See, Rev. Rul. 78-182, B.5.

he or she has written. This is because under the rules of the exchange, the two listed options cancel each other out.

From the TRA Report, it appears that Code Section 1234(b) was not intended to create a separate recognition event, but rather was intended to provide rules to fix the character of certain events: lapse, payment, or closing transactions with respect to listed options that were treated as closing transactions under the rules of the board or exchange on which the option is listed. See, e.g., Treas. Reg. §1.1234-1, which discusses Code Section 1234 in terms of the character of gain or loss recognized. See also, Treas. Reg. §1.1234-1(f), which provides that losses described under Code Section 1234 are subject to the general disallowance rules of the Code, i.e. that Code Section does not create an independent loss allowance rule, but rather any loss described in Code Section 1234 is not allowed if it would be otherwise disallowed under the Code.[5] Consequently, it is more likely than not that Code Section 1234(b)(2) would not independently cause gain or loss to be recognized by Investor upon the transfer of the Options to Fund.

Furthermore, in the context of non-traded options, the IRS has ruled that the assumption by an acquiring corporation in a corporate reorganization of warrants to purchase the target company's stock does not constitute a closing transaction, because neither did the option lapse nor did the grantor's obligation terminate. Rather, the requirement that the grantor issue stock pursuant to the warrants was assumed by the acquiror. PLR 8038087 (6/26/80) and PLR 7938018 (6/19/79)[6]. Although not directly on point, because such private letter ruling involve transactions under subchapter C of the Code rather than subchapter K, such private letter rulings support the proposition that the assumption of an undertaking to perform under an option in the context of a nonrecognition transaction is not a transaction with respect to which gain or loss is independently recognized apart from the applicable nonrecognition transaction. This should be

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5 Cf. Rev. Rul. 79-314, 1979-2 C.B. 132, and Rev. Rul. 80-101, 1980-1 C.B. 70, in which certain corporate nonrecognition rules were permitted to override general gain recognition rules, where the interpretation of the nonrecognition rules was clear.

6 Code Section 6110(k)(3) provides that a written determination, (i.e., a private ruling, determination letter, technical advice memorandum or field service advice), may not be used or cited as precedent. However, in Xerox Corp. v. U.S., 656 F.2d 659 (Ct. Cl. 1981), the court noted that although private letter rulings have no precedential value, "they are helpful, in general, in ascertaining the scope of the ... doctrine adopted by the Service and in showing that the doctrine has been regularly considered and applied by the Service."

particularly true where, as in the instant case, the legal relationship of the optionor, SMLLC, and optionee, Bank, remain unchanged.

(d) No Assignment of Income

The assignment of income doctrine is a judicially created doctrine under which the income earned from property must be included in the gross income of the person who beneficially owns the property. See, Blair v. Comm'r, 300 U.S. 5 (1937). As discussed above, it is more likely than not that the Long Option would be treated as property for purposes of Code Section 721.

An analogy may be found in two cases involving the transfer of contract claims for money damages in litigation. In Cold Metal Process Co. v. Comm'r, 247 F.2nd 864 (6th Cir. 1957), rev'g 25 T.C 1333 (1956), the IRS attempted to tax amounts received in litigation to the transferor where the transferor had transferred the claims prior to the conclusion of the litigation. The Court of Appeals, relying on the Tax Court's findings of fact, concluded that at the time of the transfer:

> there was no certainty at the time of the transfer that the transferor's rights thereto would ever be established or that the money would ever be paid to the transferor or the transferee. The amount that might eventually be collected was unliquidated.

247 F.2nd at 872.

In its analysis, the Court of Appeals distinguished a number of cases including Estate of Holmes, 1 T.C. 508 (1943), in which the Tax Court taxed dividends that were declared, but unpaid, at the time of transfer to the transferor rather than to the transferee. The Court of Appeals noted that the Tax Court considered the dividend similar to interest in that the liability and the amount were both unquestioned at the time of the transfer and that a future maturity date was the only thing that prevented immediate payment. Whereas the litigation claim was:

> an unliquidated chose in action. Cold Metal divested itself of all title, interest and control at that time. Later developments over which Cold metal had no control transformed it into taxable income which was paid to and received by the new owner for its sole benefit. These facts fall far short of classifying the transaction

as an anticipatory assignment of income taxable to the assignor when later paid.

Similarly, in Jones v. Comm'r, 306 F.2d 292 (5th Cir. 1962), rev'g T.C. Memo. 1960-115, a subcontractor transferred a claim for additional compensation that was subject to litigation between the prime contractor and the U.S. government to a corporation of which he was a majority shareholder who was a majority shareholder. The IRS asserted that upon recovery, the proceed were taxable to the transferor shareholder rather than to the transferee corporation. Based upon the fact that at the time of transfer the claim was "uncertain, doubtful, and contingent" at the time of its transfer and the transfer was "full, complete, final and definite", the Court of Appeals held that the recovery was taxable to the transferee corporation rather than the transferor shareholder. The Court of Appeals also noted that there was a commercial rationale for the transfer rather than the transfer being gratuitous.

In the instant case, the Options are contract rights similar to the claims in the Cold Metal Process Co. and Jones cases; at the time of the transfer there was no immediate right to payment or certainty as to whether an Option would settle in or out of the money; there were commercial reasons for the Investor to transfer the Options to Fund (i.e., including diversification of its portfolio without the need for additional investment, the professional management provided by the Managers, and the desire to create larger pool of capital through the involvement of other investors such as the Managers); and the transfer of the Options was not gratuitous. Consequently, based upon the Cold Metal Process Co. and Jones cases, it is more likely than not that the transfer of the Option to Fund would not constitute an anticipatory assignment of income such that income arising on the settlement of the Options that would be taxable to Investor.

Consequently, under this rule any income derived from the termination of an Option would be included in the income of its beneficial owner, the Fund, rather than in the income of the Investor.

As discussed above, it is more likely than not that the Short Option would not be treated as property for purposes of Code Section 721. Nevertheless, it is more likely than not that the rationale of these cases would equally apply to it and any income derived from the termination of the Short Option would be included in the income of its beneficial owner, the Fund, rather than in the income of the Investor.

2. Basis of Partnership Interest

(a) In General

Code Section 722 provides, in general, that the basis of a partnership interest to the contributing partner is equal to the amount of money plus the adjusted basis of the property contributed to the partnership, increased by the amount of gain, if any, recognized by the partner on the contribution under Code Section 721(b). Consequently, it is more likely than not that Investor's basis in Fund would be equal to the basis of the Long Option, increased by the gain recognized on the contribution under Code Section 721(b). As discussed below, it is more likely than not that this basis would also be increased by the Advisory Fee paid by Investor.

It is more likely than not that the transfer would be viewed as a contribution of the Long Option to Fund and Fund's assumption of the Short Option. The IRS might assert that Investor acquired an economic unit and that its basis should be its net cost for the Options. In addition, the IRS might assert that Investor acquired the Long Option in exchange, in part, for the undertakings under the Short Option. The IRS would then assert that such undertakings are too contingent to provide basis in the Long Options, leaving Investor with a basis of such net cost. As discussed at C.2, above, such positions are not supported by case law, which, as discussed above, recognizes and respects the separate nature of the transactions. In Smith v. Comm'r, supra, the court held that straddle legs should be treated as separate property whether acquired at different times or at the same time. See also, Stoller v. Comm'r, supra; Arnall v. U.S., supra. As discussed above, it is more likely than not that the Options would be treated as separate instruments.

Code Section 752(b) provides that any decrease in a partner's share of the partnership liabilities or the assumption by the partnership of a partner's individual liabilities is treated as a distribution of money from the partnership to the partner. Under Code Section 733, a partner's basis in the partnership interest is decreased by the amount of money and the adjusted basis of property other than money distributed to a partner other than in liquidation of the partner's interest. Thus, if the potential claims by Bank against Investor under the Short Option were considered liabilities for purposes of Code Section 752, Investor's basis in Fund would be reduced by such, but would be increased by Investor's share, as determined under Code Section 752, of the liabilities of Fund, including the Short Option. In addition, the amount of such liabilities would be treated as additional consideration received by Investor on the sale or

redemption of Investor's interest in Fund. See, Code Section 752(d). As discussed below, it is more likely than not that such potential claims would not be treated as liabilities for purposes of Code Section 752.

(b) Agency Doctrine Inapplicable

It is possible that the IRS might attempt to assert that Investor was acting as an agent of Fund in acquiring the Options through SMLLC. Were the IRS successful, Investor would not be treated as having contributed the Options to Fund and, as a result Investor's tax basis in Investor's membership interest in Fund would be computed without regard to the contribution of the Options by Investor to Fund.

The Supreme Court has addressed the issue of when an agency relationship exists and affects tax results of a transaction in a number of cases. In Comm'r v. Bollinger, 485 U.S. 340 (1988), a taxpayer engaged in rental real estate development, both in an individual capacity and through a series of partnerships. Since state usury law limited the rate of interest that could be charged to non-corporate debtors, at the request of the taxpayer, Bollinger formed a wholly owned corporation to be the nominal borrower. An agreement provided that the corporation would hold title to the property as the partnership's nominee and agent solely to secure financing. The partnership had sole control of and responsibility for the property and was the principal and owner during financing, construction and operation. The corporation itself had no assets, liabilities or bank accounts. In every case, the lenders regarded the partnership as the owner of the property and were aware that the corporation was acting as an agent of the partnership in holding record title. Further, the partnerships reported the income and losses generated by the property on their partnership tax returns and actively managed the properties.

Using the six-part test established in National Carbide Corp. v. Comm'r, 336 U.S. 422 (1949), the Supreme Court held that the corporation was a bona fide agent of the taxpayer and partnerships and rejected the contention of the IRS that the corporation was the true owner of the real estate developments. The six "National Carbide factors" applied were:

1) whether the corporation operates in the name and for the account of the principal;

2) whether the agent corporation binds the principal by its actions;

3) whether the corporation transmits money received for the account of the principal to the principal;

4) whether the receipt of income is attributable to the services and assets of the principal and not the agent;

5) whether the corporation is a true agent; that is, whether its relations with its principal are dependent on the latter's ownership of the agent; and

6) whether the corporation's business purpose is the carrying on of the normal duties of an agent.

The Court found that the genuineness of the agency relationship was adequately assured in this instance because (1) the relationship was set forth in a written agreement at the time each development was begun; (2) the corporation acted as an agent and not principal with respect to the development for all purposes; and (3) the corporation held itself out as the agent and not as a principal in all dealings with third parties related to the asset.

In Cottage Savings Assoc. v. Comm'r, 499 U.S. 554 (1991), the taxpayer was a savings and loan association which had large unrealized losses from its portfolio of long-term, low interest home mortgages. Due to regulatory constraints, the taxpayer was unable to sell the loans without the risk that the resulting losses would result in regulatory closure of the savings and loan. As an alternative, the taxpayer's regulator proposed that the taxpayer trade participations in various mortgages in its loan portfolios with other savings and loans with the intention that such trades would be treated as recognition events for federal income tax purposes. The taxpayer did so.

The IRS contended that the trades were not tax recognition events, arguing in part that the trades had no economic effect. The IRS argued that the taxpayer's partners in the trade were merely acting as its agents, resulting in the taxpayer's retaining de facto ownership in the "transferred" interests. In finding for the taxpayer, the Supreme Court held that the transactions did have economic effect because (1) there was no evidence that the parties had acted other than at arm's length and, (2) the taxpayer had not retained de facto ownership. The Court reasoned that because the mortgages traded involved different mortgagors and different properties securing the mortgages, there was in fact an exchange of legally distinct properties giving rise to a true economic effect for tax purposes.

In Northern Indiana Pub. Serv. Co. v. Comm'r, 115 F. 3d 506 (7th Cir. 1997), the court addressed the agency issue as well. At issue was whether a foreign subsidiary of the taxpayer carried on sufficient business activity so as to require recognition of its interest transactions with the taxpayer which would result in tax exempt treatment under the U.S./Netherlands Income Tax Treaty. The IRS took the position that the treaty was inapplicable, claiming that the subsidiary was a mere conduit or agent in the borrowing and interest paying process. The Tax Court rejected the IRS's argument and held that the subsidiary was recognizable for tax purposes and, therefore, the payments were tax exempt under the treaty. See, 105 T.C. 341 (1995). In affirming the Tax Court decision, the Court of Appeals stated that "so long as a foreign subsidiary conducts substantive business activity--even minimal activity--the subsidiary will not be disregarded for federal tax purposes, notwithstanding the fact that the subsidiary was created with a view to reducing taxes." 115 F. 3d at 511.

It is unlikely that an application of the National Carbide agency factors to the Transactions would result in a finding of agency. No indicia of a principal/agent relationship between Fund and Investor exist. Fund and Investor acted independently of one another. In acquiring the Options, Investor did not operate in the name of Fund, had no authority to bind Fund by its actions, did not transmit or receive funds on behalf of Fund, did not receive income attributable to services or assets of Fund, and did not act as a true agent or have as its business purpose the carrying out of normal duties of an agent. Furthermore, as in Bollinger, there were no agency agreements involved and no party acted as the agent of another or held itself out as an agent in dealings with third parties. Moreover, as in Cottage Savings, the parties acted at arm's length and that the transactions between them had both legal and economic significance. Finally, Investor had all of the benefits and burdens of ownership of the Options until the Options were contributed to Fund. Accordingly, it is more likely than not that the agency doctrine should not apply to the Transactions.

(c) Short Options as Liabilities

i. Code Section 752 In General

Code Section 752 itself does not define the term "liabilities".[7] In 1988, the IRS issued temporary and proposed Regulations under Code Section 752 (T.D. 8237, December 30,

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[7] Both Congress and the IRS have indicated that the terms "liability" as used in Code Sections 357, 358 and

1988) concerning the treatment of partnership liabilities. In Temp. Treas. Reg. §1.752-1T(g) the IRS defined the term "liability" for purposes of Code Section 752 as follows:

> an *obligation is a liability* of the obligor for purposes of section 752 and the regulations thereunder to the extent, but only to the extent, that incurring or holding such liability gives rise to -
>
> (1) The creation of, or increase in, the basis of any property owned by the obligor (including cash attributable to borrowings);
>
> (2) A deduction that is taken into account in computing the taxable income of the obligor; or
>
> (3) An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. [Emphasis added]

In 1991, the IRS replaced these temporary and proposed Regulations with Final Regulations. These new Regulations (T.D. 8380, 12/23/91) eliminated, without explanation, the definition of "liability" that was contained in the temporary and proposed Regulations. Nevertheless, because the definition in the 1988 temporary and proposed Regulations was based on pre-existing interpretations, and is supported by the legislative history of the Deficit Reduction Act of 1984, it may still be viewed as applicable.

The IRS's revenue rulings defining the term "liability" in the context of Code Section 752 and analogous Code Sections 357 and 358 tend to be consistent with the definition in the 1988 Regulations, requiring both an obligation and the creation of either basis, a deduction, or an expenditure that is neither deductible or chargeable to capital.

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752 are synonymous. In the 1984 tax act, Congress amended Code Section 704(c) to, *inter alia*, require that accounts payable contributed to a partnership be allocated to the contributing partner and not be treated as a liability of the partnership under Code Section 752. The conference committee report states that this treatment was intended to be "parallel to the [1978] amendment to section 357(c)", which also excludes deductible liabilities from the definition of "liability". H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess, 1984-3 (vol. 2) C.B. 110-11. In Rev. Rul. 88-77, 1988-2 C.B. 129, the IRS noted that: "The legislative history accompanying the amendment to section 704(c) made by the Tax Reform Act of 1984 explicitly rejected the conclusion reached in Revenue Ruling 60-345 in favor of an interpretation of section 752 that is consistent with section 357(c)". And in Rev. Rul. 95-74, 1995-2 C.B. 36, in support of its ruling that contingent environmental liabilities were not "liabilities" for purposes of Code Sections 357 and 358, the IRS cited Rev. Rul. 88-77, which addresses the treatment of liabilities under Code Section 752.

In addition, the IRS has taken the position that a liability does not arise prior to the time an obligation would be considered to arise under general federal income tax principles. This is confirmed in Rev. Rul. 73-301, 1973-2 C.B. 215. In the Ruling, the IRS ruled that interim payments received by a partnership for services rendered in connection with a long-term contract reported on the completed contract method do not constitute liabilities for purposes of Code Section 752. Instead, the ruling characterizes such payments as "unrealized receivables"[8], the income from which increases the basis of a partner's interest only when recognized by the partnership for tax purposes. The Ruling emphasizes that the partnership had fully earned the payments and was under no obligation to return them or perform additional services to retain them. Although the partnership received money, there was no attendant legally binding obligation to repay and, consequently, no liability. See also, Kovtun v. Comm'r, 54 T.C. 331, 338 (1970), aff'd per curiam, 448 F.2d 1268 (9th Cir. 1971), cert. denied, 405 U.S. 1016 (1972);[9] Rev. Rul. 81-241, 1981-2 C.B. 146. The IRS's position in Rev. Rul. 73-301 is consistent with the position of the Tax Court in Helmer v. Comm'r, T.C. Memo. 1975-160, discussed below.

The courts have also held that unmatured claims are not liabilities under Code Section 752. In Long v. Comm'r, 71 T.C. 1 (1978), motion for reconsideration, 71 T.C. 724 (1979), aff'd and remanded, 660 F.2d 416 (10th Cir. 1981), the court considered whether contested liabilities were liabilities within the meaning of Code Section 752. The partnership in this case was in the construction business and was sued for defects in a building. The suits were pending when the partnership was liquidated, raising the question of the partnership basis, so that the taxpayer could compute gain or loss. The court rejected the argument that the contingent claims were liabilities for purposes of Code Section 752, stating:

> Although they may be considered "liabilities" in the generic sense of the term, contingent or contested liabilities such as the Kansas City Life-TWA and USF&G claims are not "liabilities" for partnership basis purposes at least until they have become fixed or liquidated. This Court has held on a number of occasions that contingent and indefinite liabilities assumed by the purchaser of an asset are not part of the cost basis of the asset. . . . We think that

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8 Although the issue is not material to this opinion, the Options would likely not be "unrealized receivables" for purposes of Code Section 751(a).

9 In Kovtun v. Comm'r, no interest deduction was allowed to a partnership where a note was found to be unenforceable. This implies that the note was not an obligation of the partnership.

> partnership liabilities should be treated in the same manner. . . . We see no logical reason for distinguishing the above cases solely because the asset involved is an interest in a partnership, and neither party suggests such a distinction. Those liabilities should be taken into account only when they are fixed or paid. . . .
>
> The Kansas City Life-TWA and USF&G claims were too contingent at the death of the decedent to be included in the estate's initial computation of its basis in the decedent's partnership interest. Liability for those claims had not been established and was in fact contested. Moreover, the amounts of damages sought were by no means definite or fixed.

71 T.C. at 7-8 [citations omitted].

The Tax Court again held that contingent claims are not liabilities within the meaning of Code Section 752 in La Rue v. Comm'r, 90 T.C. 465 (1988). The taxpayers in this case were general partners of Goodbody & Co., a stock brokerage firm. Because of its inability to keep up with the trading volume, Goodbody incurred large "back office" liabilities due to the following types of transactions: (i) the failure to purchase securities at a stated price; (ii) the failure to sell securities at a stated price; (iii) differences between the securities actually held and the securities the partnership should have held; and (iv) the failure to receive dividends or interest on securities held for customers. Goodbody was fully liable for the losses represented by these errors. Another firm acquired the assets and assumed the liabilities of Goodbody for an amount equal to the difference between the fair market value of the assets and the liabilities. In an attempt to minimize their gain, the partners sought to increase their basis in Goodbody by including the reserves for the back office claims as partnership liabilities under Code Section 752. The court rejected this attempt, noting that the reserves were for potential liabilities, and that the amount of the liabilities was speculative and could not be determined with reasonable accuracy.

> Once the "back office" failures occurred, Goodbody incurred an obligation. The partnership was contractually obligated to its customers under the NYSE rules. Goodbody was under an obligation to replace any missing securities or money. Essentially, Goodbody's books were in error because of the back office problems, and the Haskins report reflected estimated liability figures. All of petitioners' witnesses testified that these were transactions for which the partnership was liable. There was,

> however, a contingency or speculative quality concerning the amount of Goodbody's liability. Until any missing securities were purchased or excess securities sold, at market price, there was no way of determining the amount of loss, or in some circumstances, gain.
>
> Petitioners have not shown that these amounts were determinable with reasonable accuracy. As a result of the Haskins audit, Goodbody (and Merrill Lynch) knew which particular securities would have to be sold or purchased and how much money was missing from customer accounts. However, it was not certain upon which of these claims Goodbody would ultimately be liable, because the smaller the amount of the transaction the less likely the customer would be to claim it. In addition, the exact amount of loss or gain was not determinable until actual purchase or sale. Valuation of the claims may be a purely ministerial matter because of the ready market for securities, but is not readily determinable until purchase or sale occurs. The additional reserves reflected potential liabilities of the partnership, valued by reference to listed stock prices but before actual sale or purchase and, accordingly, represented estimates. Accrual accounting requires that the amount be determinable with "reasonable accuracy." A loss is not determinable until the securities are actually purchased or sold and the transaction closed. We accordingly hold that because the reserves were not a fixed obligation of the partnership sufficiently determinable in amount in 1970, they cannot be included in the partners' bases in that year. [Footnotes omitted].

90 TC at 479.

The court stated that the "all events" test of Code Section 461(a), which is used to determine when an expense can be accrued for deduction purposes, should also be applied to determine when a liability is fixed or definite and thus includible in basis. In La Rue, the claims or obligations were too speculative and contingent to be accrued as an expense, and therefore could not be included in basis. In the present situation, at the time of the transfer to Fund the claims of Bank against Investor under the Short Option were entirely speculative and contingent (particularly since the Short Option was out of the money at the time), and the amount thereof could not be determined.

In Old Harbor Native Corp. v. Comm'r, 104 T.C. 191 (1995), the Tax Court analyzed an option contract as having two elements: "(1) a continuing offer to do an act, or to forbear from doing an act, which does not ripen until accepted; and (2) an agreement to leave the offer open for a specified or reasonable period of time." See also, Rev. Rul. 58-234, 1958-1 C.B. 279. This analysis is also consistent with the view expressed in Rev. Rul. 80-238, supra, that the writer of a call option is obligated to perform only if and when the holder exercises his or her option. This position is also consistent with Long v. Comm'r, supra, in which claims were not recognized as liabilities where liability for the claims had not been established and was contested.

In an analogous situation, under Code Section 246(c)(4) and its predecessors, the IRS has ruled that the rights of a counterparty against the writer of an out-of-the-money call option do not mature into a legal obligation until the counterparty exercises its rights under the option. Code Section 246 deals with the ability of a corporation to claim a dividends received deduction if the recipient has held the payor's stock for a requisite period of time. Code Section 246(c)(4) states in relevant part:

> The holding periods determined for purposes of this subsection shall be appropriately reduced...for any period in which –
>
> (A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities....

As noted, the statute itself distinguishes between a "contractual obligation to sell" and an "option to sell", implying that an option is not such an obligation. The IRS has specifically recognized this distinction and has ruled in Rev. Rul. 80-238, 1980-2 C.B. 96, that the writing of a call that is not in the money does not create an obligation to sell the referenced stock or security for purposes of the predecessor of Code Section 246(c)(4). This analysis was elaborated upon in G.C.M. 38305 (3/12/80), issued in connection with Rev. Rul. 80-238, which states in part:

> The writing of a call on stock owned as in the present case provides the purchaser of the call with an option to buy the underlying at a specified price within a stated period of time. See, Rev. Rul. 58-234, 1958-1 C.B. 279. If the market price of the stock were to fall during such period, reasonable business practise

would dictate that the call holder not exercise his option to obtain the underlying stock since the same stock could be purchased on the open market at the lower figure. See, Rev. Rul. 78-128, 1978-1 C.B.

The IRS addressed the issue again in a 1992 Field Service Advice, FSA 1999-704.[10] The FSA addressed a program described as a "Dividend Rollover Program" involving the acquisition of shares of stock and the writing of call options. According to the FSA, the prices of the stocks used in this program were very stable and the issuing companies had an established history of dividend payments in previously announced amounts. Consequently, the FSA concluded that the probability of a fall in the market value of the stock in excess of 14% in 18 days or less was very remote. As it turned out, all of the call options sold by the taxpayer were exercised. The FSA stated:

> *The Service's position is that a call option should be deemed an obligation to sell under section 246(c)(3) where the option's price is so deep-in-the-money that it is almost guaranteed, at the time the option is written, that the option will be exercised.* In Progressive Corp. v. United States, 970 F.2d 188 (6th Cir. 1992), the Sixth Circuit approved of the position taken by the Service in Rev. Rul. 80-238, 1980-2 C.B. 96, and remanded the case to the trial court for a determination as to whether the call options at issue in Progressive were so deep-in-the-money as to be the equivalents of the contractual obligations to sell. We think it likely that other courts will also adopt the Service's position on this issue.
>
> The determination as to whether the call option is so deep-in-the-money as to be equivalent to a contractual obligation to sell will depend on the totality of circumstances surrounding the transaction, including the amount of the difference between the strike price and the fair market value of the stock, and past market volatility of the stock involved. [Emphasis added.]

Thus, the IRS takes the position for purposes of Code Section 264(c)(4) that unless at the time the call option is written "it is almost guaranteed...that the option will be exercised", the writer of the call option is not to be treated as under a contractual obligation to

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10 See also, FSA 199904033. Although an FSA does not constitute authority that can be relied upon by a taxpayer, it is useful in understanding the position of the author on the issues addressed therein.

sell the referenced stock or security for purposes of Code Section 246(c)(4). This conclusion is consistent with the decision in Progressive Corp. v. U.S., cited in the FSA, where the court expressed a view that a call option could be so deep-in-the-money as to constitute a contractual obligation to sell, i.e. the exercise of the option was sufficiently certain to be "guarantee".[11] In the instant case, the Short Option was out of the money at the time of the transfer by Investor to Fund and was not "almost guaranteed" to be exercised at its termination.

Bank's claims against Investor under the Short Option are similar to the back office claims in La Rue, but are even less certain. Investor must make a payment under the Short Option only if the Option is in the money on the expiration date, whereas in La Rue, Goodbody had an obligation to its customers for its back office failures at the time they occurred and was merely waiting to see if claims would be filed to determine the extent and amount of its liability. Even more analogous is Long, where liability for the claims had not been established and was contested. Furthermore, under Rev. Rul. 80-238, supra, G.C.M. 38305, supra, and FSA 1999-704, it appears that the IRS view is that the obligation of the writer of an option that is not in-the-money does not arise prior to the exercise of the option by the holder.

The IRS might conceivably argue that the Short Option is a liability for purposes of Code Section 752 because it could effectively be extinguished by payment or offset at a price that is fixed and determinable by the market at any given time. First, as in La Rue, the amount for which the Short Option would have to be settled would not be known until the offsetting transaction is entered into, because the amount to be paid or cost of acquiring an offsetting contract is not known until that time. Furthermore, this argument proves too much: corporations often repurchase their common stock on the open market, in the process retiring the stock and effectively extinguishing their obligations thereunder, yet stock is clearly not a "liability" for purposes of Code Section 357. Consequently, it is more likely than not that the IRS would not be successful were it to make such an argument.

ii. The Helmer Case

In what appears to be the only decided case on point, the Tax Court agreed with the IRS that the holder's claim against the grantor of an option is not a liability within the meaning of Code Section 752. In Helmer v. Comm'r, supra, a partnership sold an option to

[11] We see no reason why this result should depend on whether the option is a call option or a put option.

purchase land that it owned and distributed the premium to the partners. The taxpayer asserted that the holder's claim against the partnership to perform under the option was a liability for purposes of Code Section 752, and thus increased his basis in his partnership interest. If the option were not considered a liability, then the amount of the premium distributed would exceed the partner's basis in the partnership, and the partner would recognize gain on the excess under Code Section 731. The court agreed with the IRS that the holder's claim against the partnership to perform under the option did not create a liability to the partnership. The partnership had no obligation to return the premium, and the premium had no restriction on its use, other than that it would be credited against the purchase price if the option were exercised.

> The option agreement, however, created no liability on the part of the partnership to repay the funds paid nor to perform any services in the future. Therefore we hold that no liability arose under code section 752 and the partners' bases cannot be increased by such amounts.

34 TCM (CCH) at 731. Likewise, a short option contract creates no obligation to return the premium to the purchaser. Indeed, the premium represents deferred income to the seller and is not a liability.

Consequently, based upon the Helmer case, and the authorities cited in the previous Section of the letter, it is more likely than not that a Short Option would not be considered a "liability" for purposes of Code Section 752.

iii. Treatment of Short Sales

In Rev. Rul. 95-26, 1995-1 C.B. 131, the IRS ruled that a partnership obligation to return securities sold short creates a partnership liability for purposes of Code Section 752. The Ruling addressed each prong of the obligation/deduction-basis-capital test. First, it maintained that a short sale created an obligation to return the securities borrowed to effect the sale. Second, the Ruling maintained that the cash proceeds of the short sale create a partnership asset, thereby increasing basis and bringing the obligation within the definition of liability based upon the logic of Rev. Rul. 88-77.[12]

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[12] Rev. Rul. 95-45, 1995-1 C.B. 53 applies a similar analysis to characterize the short-sale obligation of a shareholder who contributes its interest in the sales proceeds, in conjunction with a Code Section 351

In Salina Partnership LP, FPL Group, Inc. v. Comm'r, T.C. Memo 2000-352, the taxpayer purchased a 98% interest in Salina Partnership LP, a Delaware limited partnership. Among the transactions that Salina had entered into prior to taxpayer's purchase was a short sale of U.S. Treasury bills. Under Regulations then in effect, the purchase of 50% or more of the interests in a partnership within a 12 month period caused a constructive termination of the partnership, involving a deemed liquidation of the "old" partnership and a contribution of the assets, subject to partnership liabilities to a "new partnership". As a result of the constructive termination, the "new" partnership received the Treasury bills subject to the "old" partnership's undertakings under the short sale. The IRS contended that such undertakings constituted liabilities for purposes of Code Section 752, whereas the taxpayer contended that the undertakings did not. The Court concluded that the partnership's obligation to close its short sale by replacing the Treasury bills that it had borrowed represented a partnership liability for purposes of Code Section 752.

In making its argument that the short sale did not create such a liability, the taxpayer relied upon Helmer, supra, for the proposition that an "open transaction" did not create a liability. The court distinguished the option in Helmer from a short sale, stating that a short sale transaction and the writing of an option are "materially different" because the option in Helmer, as is the case with the Short Options, created no claim for repayment or demand for further services. Thus the court implicitly affirmed its decision in Helmer that an option which may expire unexercised is not a liability for purposes of Code Section 752.

Based upon the foregoing, it is more likely than not that Rev. Rul. 95-26, supra, would be distinguishable from the Fund's indirect assumption of obligations under the Short

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incorporation of a going business, as a liability for purposes of Code Section 357 (which treats liabilities transferred in incorporations as taxable "boot" to the extent in excess of the basis of the transferred property) and Code Section 358 (which treats transferred liabilities as money received in calculating the basis of the transferor's stock). Applying the same reasoning as in Rev. Rul. 95-26, Rev. Rul. 95-45 cites Deputy v. du Pont, 308 U.S. 488 (1940) for the proposition that a short sale creates an obligation to return the borrowed securities. Because that obligation results in an increase in asset basis, the ruling concludes that the obligation constitutes a "liability," even though acknowledging that the sales proceeds are not currently taxable. In contrast, Rev. Rul. 95-8, 1995-1 C.B. 107, although issued in conjunction with the other two rulings, holds that an exempt organization's income from a short sale does not result in unrelated business taxable income under Code Section 511 from "debt-financed property" under Code Sections 512(b)(4) and 514(a) and (b). Its rationale is that there is no "acquisition indebtedness" within Code Section 514(c) because under Deputy v. du Pont, 308 U.S. 488 (1940), supra, a short-sale obligation creates an "obligation" but not an "indebtedness."

Option, because as recognized in the Salina case, the short sale creates a legally enforceable obligation to deliver securities, whereas an option does not create a similar obligation. It is the creation of such an enforceable obligation, coupled with the receipt of sale proceeds by the partnership that allowed the IRS to bootstrap itself into the liability conclusion reached by the Ruling. See also, Rev. Rul. 88-77, supra, cited in the Ruling, that also involved noncontingent, legally enforceable obligations. As discussed above, the requirement to perform under an option is not treated as fixed or legally enforceable at the time the option is entered into.[13]

In the present situation, the Short Option is a European-style option, which means that it could only be exercised or settled on its termination date,[14] and at the date of transfer it was out of the money. Thus, at the time of the transfer the claims of Bank against Investor under the Short Option were entirely speculative and contingent, because it was unknown whether the Short Option would be in the money on termination.

iv. 2000 Legislation

On December 15, 2000 the House and Senate passed H.R. 5662. Section 309 of H.R. 5662 provides:

> PREVENTION OF DUPLICATION OF LOSS THROUGH ASSUMPTION OF LIABILITIES GIVING RISE TO A DEDUCTION.

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13 In Rev. Rul. 95-74, 1995-2 C.B. 36, the IRS concluded that contingent environmental liabilities are not liabilities for purposes of Code Section 358/357(c), but, while admitting that the liabilities were not fixed or enforceable, the Ruling reached its conclusion by relying on Code Section 357(c)(3)(A), which excludes deductible liabilities from Code Section 357(c). This Ruling could be read as treating contingent liabilities as liabilities under Code Section 357(c) (and presumably the partnership analog of Code Section 752) unless they do not give rise to an asset, are deductible, or otherwise fit within an exception under Code Section 357(c)(3). However, this reading is belied by a recent FSA in which the IRS addressed the issue of whether a contingent liability is the type of liability that is to be taken into account for purposes of I.R.C. sections 357 and 358. The FSA stated: "However, because of the specific language of I.R.C. sections 357(c)(3) and 358(d)(2), as interpreted by Rev. Rul. 95-74, 1995-2 C.B. 36, we do not believe that it is necessary to address this broader issue. That is, we will assume for purposes of the following discussion that such contingent liability is the type of liability to be taken into account currently under I.R.C. sections 357 and 358." The FSA goes on to analyze the obligations under Code Section 357(c)(3). FSA 199905008 (10/29/98). Consequently, it appears that the IRS has not reached the conclusion that contingencies themselves do not keep the obligation from being a "liability" for purposes of Code Sections 357/752.

14 This is to be distinguished from American-style options that can be exercised at any time on or before their termination date.

(a) IN GENERAL. -- Section 358 [of the Internal Revenue Code of 1986] (relating to basis to distributees) is amended by adding at the end the following new subsection:

"(h) SPECIAL RULES FOR ASSUMPTION OF LIABILITIES TO WHICH SUBSECTION (d) DOES NOT APPLY.--

"(1) IN GENERAL. -- If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a)(1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability --

"(A) which is assumed in exchange for such property, and

"(B) with respect to which subsection (d)(1) does not apply to the assumption.

"(2) EXCEPTIONS. -- Except as provided by the Secretary, paragraph (1) shall not apply to any liability if --

"(A) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or

"(B) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.

"(3) LIABILITY. -- For purposes of this subsection, the term 'liability' shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title."

(b) DETERMINATION OF AMOUNT OF LIABILITY ASSUMED. -- Section 357(d)(1) of the internal Revenue Code of 1986 is amended by inserting "section 358(h)," after "section 358(d),".

(c) APPLICATION OF COMPARABLE RULES TO PARTNERSHIPS AND S CORPORATIONS. -- The Secretary of the Treasury or his delegate --

> (1) shall prescribe rules which provide appropriate adjustments under subchapter K of chapter 1 of the Internal Revenue Code of 1986 to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) of such Code (as added by subsection (a)) in transactions involving partnerships, and
>
> (2) may prescribe rules which provide appropriate adjustments under subchapter S of chapter 1 of such Code in transactions described in paragraph (1) involving S corporations rather than partnerships.
>
> (d) EFFECTIVE DATES. --
>
> (1) IN GENERAL. -- The amendments made by this section shall apply to assumptions of liability after October 18, 1999.
>
> (2) RULES. -- The rules prescribed under subsection (c) shall apply to assumptions of liability after October 18, 1999, or such later date as may be prescribed in such rules.

In the instant case, Investor transferred all of the assets to which the Short Option was associated to Fund. Consequently, it is more likely than not that the exception contained in Code Section 358(h)(2), as added by Section 309 of H.R. 5662 would apply with the result that it is more likely than not that the Short Option would not be considered to be an obligation of Investor that would constitute a liability for purposes of Code Section 358 (and therefore under Regulations to be issued, Code Section 752) under Section 309 of H.R. 5662.

v. Summary

It is more likely than not that the Short Option would not be considered a liability for purposes of Code Section 752.

vi. Amount of Liability

Even if the undertaking under the Short Option were considered a liability, it is more likely than not that Investor's basis in Fund would not be affected. This is because it is more likely than not that the amount of the "liability" would be considered zero. In Rev. Rul. 95-45, 1995-1 C.B. 53, the taxpayer sold securities short and contributed the $1,000x proceeds

and the short sale obligation to a corporation in exchange for stock in a Code Section 351 transfer. At the time of the transfer, the value of the securities was $800x. The IRS concluded that the short sale obligation was a liability, and that the amount of the liability was $1,000x.

If the IRS is correct that the amount of the liability is determined by the original value of the securities to be delivered, the Short Option is distinguishable. We have been advised by Managers that at the time that the Short Option was created, it was out of the money. Consequently, Investor would not have had to transfer anything to satisfy Investor's undertaking under the Short Option. By contrast, the short seller would have had to transfer securities worth $1,000x. The IRS might assert that the amount of the liability is not the actual amount of the liability but the amount included in basis. This argument produces an incorrect result in other contexts, and should be rejected here. To illustrate, assume that a taxpayer purchases an asset with $1,000x of borrowed funds, repays a portion of the loan with other assets, and then contributes the property and the liability to a corporation. Under the IRS approach, the taxpayer's basis under Code Section 358 in the stock received would be reduced by $1,000x, the original amount of the loan included in basis. This is clearly the incorrect result, and it is more likely than not that basis would be reduced only by the actual amount of the liability. In the case of an out-of-the-money option, this must be zero.

Furthermore, the amount of the liability is not the amount that the obligor might have to pay the obligee currently to free himself of the obligation. Accord, Rev. Rul. 95-45, supra, where the short seller received $1000x in sale proceeds and contributed them in a Code Section 351 transfer when replacement securities would cost $800x. The transferee assumed the transferor's obligations to deliver identical securities. The IRS ruled that the assumed obligation was a "liability" in the amount of $1000x.

Similarly, except in the case of the original issue discount rules (which are an overlay on the common tax law of debt obligations and in any event apply only after a *de minimis* threshold), the amount of a debt obligation for tax purposes is set when the obligation is issued: it does not change with fluctuations in interest rates or the issuer's credit rating, even though these changes would affect the value of the debt obligation and therefore the amount that an economically rational issuer would pay the holder to discharge the debt. Also, while discharge of indebtedness income is measured by the original issue price and not by the face amount, for numerous other tax purposes the amount of a debt obligation is its face amount, i.e.,

the amount that the holder would receive at maturity. See, e.g., Code Sections 144(a)(1), 148(f)(4)(D), 453A(c)(4), 691(a)(5)(B).

3. Capitalization of the Advisory Fee

Code Section 212(1) allows the deduction of all "ordinary and necessary" expenses paid for the production or collection of income. In part because of this "ordinary and necessary" language, Code Section 212(1) is generally considered the non-business analogue of Code Section 162, which permits the deduction of "ordinary and necessary" business expenses. For purposes of Code Section 162 - and therefore for purposes of Code Section 212(1) as well - an "ordinary" expense is one which is not capital. Treas. Reg. §1.212-1(n); Comm'r v. Tellier, 383 U.S. 687 (1966).

In Rev. Rul. 53-3, 1953-1 C.B. 37, M Co. was the custodian, and N Co. the sponsor, of an investment plan established to enable investors to acquire and hold X Corp. stock. Investors paid a "creation" fee to the sponsor for its services in connection with the development, sale and administration of the plan. They also paid a "custody" fee to the custodian for his services in collecting the cash dividends, reinvesting them in stock, maintaining individual records and mailing statements to the investors. In practice, the custodian deducted both fees from the investment, retained the custody fee and paid the creation fee to the sponsor. The IRS held under the 1939 Code that the custody fee was deductible as a nonbusiness expense, but the creation fee was a capital expenditure because the "dominant service" performed by the sponsor was to make possible the acquisition of shares of stock under favorable terms.

In Vestal v. U.S., 498 F.2d 487 (8th Cir. 1974), the taxpayer, one John Daniel, had been brought into an oil investment partnership by Vestal and had agreed to Vestal certain sums for doing so. Daniel attempted to deduct the payments, made when the investment was sold, as expenses for the production of income. The court held that the payment must be capitalized, stating:

> Here, the impetus for the investment came from Vestal who undertook to raise the balance of about $250,000 needed for additional capital by Olds, Ltd. Vestal thought the investment attractive and undertook to sell the proposal to Daniel and others. This transaction between Vestal and Daniel was isolated and spontaneous. Daniel offered no evidence that he had requested

> Vestal to find him oil investments or that he had retained Vestal to provide him with advice as a consultant.
>
> The payments made by Daniel was the price which Vestal exacted in return for bringing to Daniel this investment opportunity. Thus, the payments made by Daniel to Vestal to obtain the investment must be characterized as a commission or finder's fee and must be deemed "costs incurred in the acquisition or disposition of a capital asset * * * to be treated as capital expenditures." *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), *affirming* 410 F. 2d 313 (8th Cir. 1969). *See Helvering v. Winmill*, 305 U.S. 79 (1938); *Helgerson v. United States*, 426 F. 2d 1293 (8th Cir. 1970). Accordingly, these amounts are not deductible as ordinary and necessary expenses but instead must be added to Daniel's basis in his partnership interest as a capital expenditure incurred in the acquisition of an asset.

In Honodel v. Comm'r, 76 T.C. 351 (1981), aff'd, 722 F2d 1462 (9th Cir. 1984), the taxpayer acquired a limited partnership interest recommended by FMS, an investment planning service. As the appeals court explained the problem:

> FMS charged fees in two separate methods. First, clients were charged monthly nonrefundable retainer fees, the amount depending on that individual's income level and his financial planning, tax advice, and investment needs. Second, when a client elected to invest in a project, a flat investment fee representing a specific percentage of the total cost of the project was assessed. Each investor in a particular project paid according to his or her respective ownership interest. The retainer fee was fixed by FMS reflecting FMS' time and effort expended in selecting that specific project, and the costs of analyzing the numerous projects which FMS had rejected.

The Tax Court held that the retainer fee was deductible, but that the flat fee had to be capitalized in the cost of the partnership interest because it originated in the process of the acquisition of property. As the Tax Court explained:

> Only those clients who decided to invest in a recommended project and took advantage of FMS's acquisition function paid the investment fees. Those clients who chose not to invest and hence were not required to pay the investment fee received the exact

> same investment services as those who chose to invest. Conversely, petitioners could only participate in an investment if they paid the investment fee. Each petitioner voluntarily could choose to invest in the projects. Each was cognizant of the fact that a decision to invest resulted in the imposition of this investment fee. This investment fee was a cost of acquiring an interest in the limited partnership projects herein.

76 T.C. at 367.

Because the Advisory Fee paid by Investor originated in the acquisition of a partnership interest, it is more likely than not that the Advisory Fee would treated as a cost of acquiring an interest in Fund and therefore would be included in the basis of Investor's interest in Fund.

It is also possible that all or a portion of the Advisory Fee would be treated as an organization or syndication fee under Code Section 709(a), that is, an amount paid or incurred to organize a partnership or promote the sale of interests therein. Organization fees paid by a partnership may be capitalized and, at the partnership's election, amortized over 60 months, and syndication fees are non-deductible. An amount paid by partner as an organization or syndication expense fee would be deemed to have been contributed by the partner to the partner as a contribution to capital, and then paid by the partnership. This deemed capital contribution would increase the partner's outside basis in his partnership interest. Rev. Rul. 89-11, 1989-1 C.B. 179 (syndication fees). It could then contribute to a loss (or reduce a gain) upon the partner's sale or liquidation of his partnership interest. Cf., Rev. Rul. 87-111, 1987-2 C.B. 160 (organization fees as to which no election to amortize over 60 months has been made); McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners ¶4.07 at fn. 212 (2000, CUM 4th Supp. No. 2).

E. Activities of Fund

1. Tax Basis of the Long Option

Under Code Section 723, Fund's basis in the Long Option will equal Investor's basis in the Long Option, increased by any gain recognized to Investor under Code Section 721(b) on the contribution.

2. Status of Fund as a Dealer, Trader, or Investor

Under federal tax common law, a dealer is one who holds himself out to the public as buying property for resale. A trader is one who buys and sells in frequent and continuous operations for his own account, generally with the aim of profiting from short-term appreciation in values. An investor is one whose buying and selling activities are limited to occasional transactions, and who generally intends to profit from long-term appreciation. See, generally, Whipple v. Comm'r, 373 U.S. 193 (1963); Levin v. U.S., 597 F.2d 760, 765 (Ct. Cl. 1979); Moller v. U.S., 721 F.2d 810 (Fed. Cir. 1983). Under these principles, it is more likely than not that Fund would not be a dealer, and could be a trader. See, FSA 200025020, supra. Whether it is a trader or investor should have no material tax consequence to Investor or Fund.

3. Termination of the Options

Under the general federal income tax rules regarding the taxation of the Options, discussed above, Fund recognizes gain or loss when the Options expire or Fund otherwise disposes of them in a taxable transaction, and it is more likely than not that gain or loss on the Long Option would equal the difference between the Fund's basis therein and its value at the time of disposition or the consideration received for it. While no written guidance appears to exist on this issue, gain or loss on the Short Option would more likely than not equal the difference between (i) the original proceeds received by the Investor, reduced by any gain and increased by any loss recognized by the Investor on the assignment to Fund and (ii) the value of the Short Option to the Bank at the time of disposition or expiration (or the amount paid by Fund to relieve itself of the obligation under the Short Option).

Consequently, based upon the discussion of the general federal income taxation of Options above, it is more likely than not that gain or loss would be recognized and realized upon the settlement of the option.

As discussed above, it is more likely than not that neither the assignment of income doctrine nor the open transaction approach to the taxation of options would cause any income recognized on the termination or other disposition of the Options by Fund to be taxable to Investor. As a result, it is more likely than not that any such income or loss would be treated as recognized by Fund. Consequently, it is more likely than not that under Code Sections 702 and 704 each Fund member would be allocated such member's distributive share of this gain or loss,

and under Code Section 705, each Fund member's distributive share of this gain or loss will be reflected in such member's outside basis in his membership interest.

F. Withdrawal from Fund

1. Recognition of Gain or Loss

When Investor withdrew from Fund, Investor received a liquidating distribution of Partnership assets equal to the then value of Investor's Partnership interest. Code Section 731(a) provides that a partner does not recognize gain on the distribution of property from a partnership, except to the extent that the amount of money received exceeds the partner's adjusted basis for the partnership interest. Loss is recognized only if the property distributed consists solely of money, unrealized receivables and inventory. Code Section 731(b) provides that a partnership does not recognize gain or loss on the distribution to a partner of property, including money. However, in 1994, Congress amended Code Section 731 to provide that the term "money" would include "marketable securities," which would include the Financial Assets. On Investor's withdrawal from the Fund, Investor received a distribution of cash and Financial Assets.

However, Code Section 731 (c)(3) provides that this special definition will not apply if the Fund is an "investment partnership" and each partner is an "eligible partner." Code Section 731(c)(3)(C)(i) defines an "investment partnership" as any partnership that has never been engaged in a trade or business and substantially all of the assets of which consists of money, stock, notes, bonds, debentures, interest rate, currency or equity notional principal contracts, foreign currencies, and specified other marketable securities. An "eligible partner" is any partner who has not contributed to the partnership any property other than that described in Code Section 731(c)(3)(C)(i).

Because the Fund is not engaged in any activity other than investing in the types of securities listed in Code Section 731 (c)(3)(C)(i), distributions to Investor of Financial Assets should not be considered money for purposes of Code Section 731 (a). Consequently, because Investor's tax basis in its Fund interest exceeded the amount of cash distributed (or deemed distributed under Code Section 752), it is more likely than not that Investor would not recognize gain on the distribution in redemption of Investor's Fund interest. Furthermore, under Code Section 731(b), the Fund should not recognize gain or loss on the distribution in redemption of Investor's Fund interest. Lastly, Investor's withdrawal from Fund would, more likely than not, not cause Investor to recognize the premium income on the Short Option (if held by Fund upon

such withdrawal) because, as discussed above, such withdrawal did not cause the Short Option to "terminate".

2. Basis of Property Distributed

Upon a complete liquidation of a partner's partnership interest, Code Section 732(b) provides that the basis of any distributed property is equal to the partner's basis in its partnership interest immediately prior to the distribution, reduced by any actual cash received. Under Code Section 732(c), if the basis of the distributee's partnership interest after reduction for any money received exceeds the partnership's basis in distributed unrealized receivables and inventory, each of these assets is allocated a basis equal to its basis to the partnership and the balance of the partner's basis in its partnership interest is allocated to other distributed assets as follows:

> First, each other distributed asset is provisionally assigned a basis equal to its pre-distribution partnership basis.
>
> If the provisional bases so assigned are less than the remaining basis to be allocated, the excess basis is allocated first to increase the bases of any appreciated assets so as to reduce all differences between values and bases proportionately, with any remaining excess basis allocated to all other distributed assets in proportion to their respective fair market values.

Based upon the forgoing, it is more likely than not that upon termination of Investor's interest in the Fund Investor's adjusted basis in its Fund interest, plus or minus its allocable share of Fund income or loss, is reduced by the amount of cash received and deemed received under Code Section 752 and the residual amount is allocated to the Financial Assets distributed under the methodology described above.

3. Consequences to Fund

The general rule is that a partnership does not adjust the basis of its remaining assets to reflect the distribution of property to a partner. Code Section 734(a). However, a special election is available under Code Section 754 that would allow such an adjustment. Fund has represented that it has not made this election, and thus Fund will not be required to adjust the basis of its assets to reflect the distribution to Investor of the Financial Assets.